Treasury Management Strategy 2014/15 – 2016/17

1. The treasury management service is an important part of the overall financial management of the PCC's affairs. The prudential indicators in **Annex A** consider the affordability and impact of capital expenditure decisions, and set out the PCC's overall capital framework. The treasury service considers the effective funding of these decisions. Together they form part of the process which ensures the PCC meets its balanced budget requirement under the Local Government Finance Act 1992.

2. The PCC's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). This organisation adopted the Code of Practice on Treasury Management in January 2013.

3. As a result of adopting the Code the organisation also adopted a Treasury Management Policy Statement (January 2013). This adoption is the requirements of one of the prudential indicators.

4. The PCC is required to receive and approve, as a minimum, three main reports each year

   - The annual strategy outlining the expected treasury activity for the forthcoming 3 years. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service.

   - A mid year treasury management report. This updates the PCC of progress against the indicators and Treasury Management performance. Monitoring reports will usually be taken to the Strategic Governance Board twice a year.

   - An annual treasury management report. This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to estimates within the strategy. The annual report is taken to the Strategic Governance Board in June.

5. This annual strategy covers:

   - The PCC's debt and investment projections;
   - The PCC's estimates and limits on future debt levels (limits to borrowing);
   - The expected movement in interest rates;
   - The PCC's borrowing and investment strategies;
   - Treasury performance indicators;
   - Specific limits on treasury activities;

Debt and Investment Projections 2014/15 – 2016/17

6. The PCC's treasury portfolio position at 31 March 2013, with forward projections are summarised below. The table below shows the actual external debt (the treasury management operations) against the underlying capital borrowing need (the Capital Financing Requirement – CFR), highlighting any over or under borrowing.

	2012/13 Actual £m	2013/14 Revised £m	2014/15 Estimated £m	2015/16 Estimated £m	2016/17 Estimated £m
External Debt					
Debt at 1 April	8.652	8.106	7.103	6.557	6.011

Expected change in debt	(0.546)	(1.003)	(0.546)	(0.546)	(0.546)
Other Long Term Liabilities	13.715	13.466	12.683	12.022	11.123
Gross Debt at 31 March	**21.821**	**20.569**	**19.240**	**18.033**	**16.588**
CFR	31.466	30.228	28.887	27.684	26.261
Under/ (over) borrowing	9.645	9.659	9.647	9.651	9.673

7. Within the prudential indicators there are a number of key indicators to ensure the PCC operates within well defined limits.

8. One of these is that the PCC needs to ensure that total gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2014/15 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

9. The Treasurer reports that the PCC complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this capital programme report.

Treasury Indicators - Limits to Borrowing Activity

10. The Operational Boundary – this is based on the probable external debt during the course of the year; it is not a limit and actual borrowing could vary around this boundary for short times during the year. The limit is set using the start of year external debt figures plus a contingency for the overdraft limit plus long term liabilities (PFI).

Operational Boundary	2013/14 Revised £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
Borrowing	9.0	8.1	7.5	7.0
Other long term liabilities	13.8	13.5	12.7	12.0
Total	22.8	21.6	20.2	19.0

11. The Authorised Limit for External Debt – A further key prudential indicator represents a control on the overall level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the PCC. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

12. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all Authorities' plans, or those of a specific Authority, although no control has yet been exercised.

13. The PCC is asked to approve the following Authorised Limit:

Authorised limit	2013/14 Revised £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
Borrowing	17.1	16.6	16.0	15.5
Other long term liabilities	13.5	12.7	12.0	11.1
Total	30.6	29.3	28.0	26.6

14. The figures for the proposed authorised limit for 2014/15 take into account:

(a) The estimated amount of outstanding borrowing approvals on capital expenditure at 31 March 2014 (£6.582m) plus borrowing of £0.520m regarding transferred debt from Derbyshire County Council and Derby City Council which remains outstanding, which arose upon reorganisation.

(b) New external borrowing for capital schemes during 2014/15 (it is not intended to take out any borrowing in 2014/15) less the estimated amount for debt redemption within 2014/15 loan charges (£0.546m).

(c) The amount of any short-term borrowing pending receipt of grant on capital schemes. The estimated maximum figure for 2014/15 is £1.0m.

(d) The amount of any short-term borrowing pending receipt of revenue income. This should be minimal, but in order to cover any unforeseen changes in cash flow patterns (for example the timing of receipt of Government Grants in 2014/15), it is suggested a figure of £9m be used.

(e) Other long-term liabilities are an allowance for items such as the capital value of qualifying property leases or finance leases which may arise. The figure for 2014/15 includes £12.684m for PFI Liabilities.

15. Based on the above, it is proposed that the authorised limit for outstanding debt should be set at £29.2m for 2014/15. Proposed limits for future years have been calculated in a similar manner taking into account the future borrowing requirements.

Expected Movement in Interest Rates

16. The PCC has appointed Capita Asset Services as its treasury advisor and part of their service is to assist the PCC to formulate a view on interest rates. The following table gives the Sector central view.

Annual Average %	Bank Rate	Money Rates		PWLB Borrowing Rates		
		3 month	1 year	5 year	25 year	50 year
Mar 2014	0.50	0.50	0.80	2.50	4.40	4.40
June 2014	0.50	0.50	0.80	2.60	4.50	4.50
Sept 2014	0.50	0.50	0.80	2.70	4.50	4.50
Dec 2014	0.50	0.50	0.80	2.70	4.60	4.60
Mar 2015	0.50	0.50	0.80	2.80	4.60	4.70
June 2015	0.50	0.50	0.80	2.80	4.70	4.80
Sept 2015	0.50	0.50	0.90	2.90	4.80	4.90
Dec 2015	0.50	0.50	1.00	3.00	4.90	5.00
Mar 2016	0.50	0.50	1.20	3.10	5.00	5.10

June 2016	0.75	0.60	1.40	3.20	5.10	5.20
Sept 2016	1.00	0.70	1.60	3.30	5.10	5.20
Dec 2016	1.00	0.90	1.80	3.40	5.10	5.20
Mar 2017	1.25	1.00	2.00	3.40	5.10	5.20

17. Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth has rebounded during 2013 to surpass all expectations. Growth prospects remain strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. One downside is that wage inflation continues to remain significantly below CPI inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. A rebalancing of the economy towards exports has started but as 40% of UK exports go to the Eurozone, the difficulties in this area are likely to continue to dampen UK growth. There are, therefore, concerns that a UK recovery currently based mainly on consumer spending and the housing market, may not endure much beyond 2014. The US, the main world economy, faces similar debt problems to the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth.

18. The current economic outlook and structure of market interest rates and government debt yields have several key treasury management implications:

    - Although Eurozone concerns have subsided in 2013, Eurozone sovereign debt difficulties have not gone away and there are major concerns as to how these will be managed over the next few years as levels of government debt to GDP ratios, in some countries, continues to rise to levels that could result in a loss of investor confidence in the financial viability of such countries. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;
    - Investment returns are likely to remain relatively low during 2014/15 and beyond;
    - Borrowing interest rates have risen significantly during 2013 and are on a rising trend. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring even higher borrowing costs, which are now looming ever closer, in the event that the PCC will not be able to avoid new borrowing to finance new capital expenditure in the near future.
    - There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

Borrowing Strategy 2014/15 – 2017/18

19. The PCC is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the PCC's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is high.

20. The uncertainty over future interest rates increases the risks associated with treasury activity. As a result the PCC will continue to take a cautious approach to its treasury strategy

21. It is assumed that no external borrowing will take place in 2014/15 to 2017/18.

22. External borrowing may be taken out in future years for capital purposes over a period to be determined at that time. The main source of new loans has previously been the Public Works Loans Board (PWLB), which it is estimated could provide all of the PCC's requirement. Historically the PWLB has offered the lowest rates, however, the banking sector may be competitive from time to time. Consequently it is recommended that the approved source of borrowing should be both PWLB loans and the London Money Market. In 2012/13 the Government introduced the certainty rate discount on PWLB loans which enables eligible local authorities to access cheaper borrowing, a 20 basis points discount on loans from the PWLB. Borrowing would have to feature in the force's long-term plans in order for it to qualify for this discount.

23. Borrowing in advance of need – Some Authorities may borrow funds in advance for use in future years. This may occur where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. A cautious approach should be adopted for any such borrowing, but where there is a clear business case for doing so borrowing may be undertaken to fund the approved capital programme or to fund future debt maturities. This is not an approach that has been adopted by this Derbyshire Police, if this was proposed in the future it would be reported to the Strategic Governance Board for approval.

24. Debt Rescheduling/Repayment – Consideration will be given to rescheduling or repayment of debt prematurely. Any savings from rescheduling/repayment of debt would have to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred). It is considered that the proposal to repay the outstanding loan for the Helicopter Unit in 2013/14 is sound and will benefit the force's Treasury Management position.

Treasury Management Limits on Activity

25. There are three further debt related treasury activity limits. The purpose of these are to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance. The indicators are:

Upper limits on variable and fixed interest rate exposure

Recommended upper limits on the percentage of borrowing and investments held at fixed and variable rates, as required by the Code, are set out below:

	2014/15 Upper	2015/16 Upper	2016/17 Upper
Borrowing			
Limits on fixed interest rates	100%	100%	100%
Limits on variable interest rates	30%	30%	30%

Investments			
Limits on fixed interest rates	20%	20%	20%
Limits on variable interest rates	100%	100%	100%

For investments, fixed interest rates are deemed to apply to loans for more than one year.

Limits set at these levels will provide for efficient debt management, within an acceptable degree of risk. For the purposes of the Code, investments are to be deducted from borrowing to produce adjusted limits, but within the above parameters.

26. **Maturity structures of borrowing**

The maturity profile is the rate at which long-term loans have to be repaid to the PWLB (or other lenders). It would be imprudent to have a large proportion of repayments in any one year, thus a spread of redemption's is desirable.

Currently most of the PCC's loan debt is repayable over the next 25 years. Two loans are repayable on maturity but one of these is for the Helicopter Unit and it is proposed that this is repaid early.

The maturity structure is a prudential indicator under the Code, with lower and upper limits recommended as shown in the table below.

Maturity Structure of fixed interest rate borrowing			
		2014/15	**Currently**
Under 12 months	Lower-Upper	0%-10%	7.1%
12 months to 2 years	Lower-Upper	0%-10%	7.1%
2 years to 5 years	Lower-Upper	0%-30%	21.2%
5 years to 10 years	Lower-Upper	0%-40%	32.6%
10 years and above	Lower-Upper	25%-90%	32.0%

Investment Strategy 2014/15 – 2016/17

27. **Investment Policy -** The PCC's investment policy has regard to the CLG'S Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The PCC's primary objectives are safeguarding the re-payment of the principal and interest of its investments on time first and ensuring adequate liquidity second – the investment return then being a third objective.

28. In accordance with the above guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the PCC has below clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings, watches and outlooks published by all three ratings agencies with a full understanding of what these reflect in the eyes of each agengy. Using the Capita Asset Services ratings service, banks' ratings are monitored on a real time basis

with knowledge of any changes notified electronically as the agencies notify modifications.

29. Further, the PCC's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets.

30. Other information sources used will include the financial press, share prices and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

31. The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus the avoidance of concentration risk. The intention of the strategy is to provide security of investment and minimisation of risk.

32. Investment instruments identified for use in the financial year are listed in Appendix B1 under the 'Specified' and 'Non-Specified' Investments categories.

33. **Creditworthiness policy -** The primary principle governing the PCC's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the PCC will ensure:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security.
- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the PCC's prudential indicators covering the maximum principal sums invested.

34. The Treasurer will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to the PCC for approval as necessary. These criteria are separate to those which determine Specified and Non-Specified investments (see Appendix B1) as they provide an overall pool of counterparties considered high quality the PCC may use rather than defining what types of investment instruments are to be used.

35. The rating criteria use the **lowest common denominator** method of selecting counterparties and applying limits. This means that the application of the PCC's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies and one rating meets the PCC's criteria and the other does not, then the institution will fall outside the lending criteria. Credit rating information is supplied by Capita Asset Services, our treasury advisors, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty list. Any rating changes are provided to officers almost immediately after they occur and this information is considered before dealing.

36. The criteria for providing a pool of high quality investment counterparties (both Specified and Non-specified investments) is:

- **Banks/Building Societies 1 - Good Credit Quality** – the PCC will only use UK banks and Building Societies which have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated):
- **Short Term Rating-** F1 (or equivalent) from Fitch, Moody's (P-1) or S&P's (A-1)

1. **Long Term Rating-** A (single A category) or equivalent from Fitch, Moody's or S&P's.
2. **Viability/Financial Strength –** bb+ (Fitch/Moody's only)
   Note: Individual ratings previously supplied by Fitch have changed to a wider viability rating
3. **Support –** 3 (Fitch only)

- **Banks 2** – Part nationalised UK banks – Lloyds Bank and Royal Bank of Scotland. These banks can be included if they continue to be part nationalised or they meet the ratings in Banks 1 above.
- **Banks 3** - The PCC's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.
- **UK Government** (eg Debt Management Account Deposit Facility (DMADF))
- **Local Authorities**
- **Money Market Funds –** "AAA" rated by Fitch, Moody's and S&P

37. **Country and sector considerations** – the PCC will only invest in UK banks and building societies with the above ratings.

38. **Use of additional information other than credit ratings** – Additional requirements under the Code require the PCC to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, Capita Asset Services provide a colour coded counterparty list on a weekly basis. This incorporates credit ratings, rating watches, rating outlooks and market information such as Credit Default Swap prices which results in suggested investment durations. This additional market information (for example negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

39. **Time and Monetary Limits applying to Investments** – The time and monetary limits for institutions on the PCC's Counterparty List are as follows (these will cover both Specified and Non-Specified Investments):

	Fitch (or equivalent)	**Money Limit (group)**	**Time Limit**
Banks/Building Societies 1 - Upper Limit	*F1+ (S/T)* *AA- (L/T)*	£10m (£3m if > 365 days)	2yrs
Banks/Building Societies 1 – Middle Limit	F1 (S/T) A- (L/T)	£6m	1yr
Banks 2 Part nationalised banks	N/A	£10m	1yr
Banks 3 PCC's banker		£10m	1yr
Money Market Funds	AAA	£10m	1yr

Debt Management Account Deposit Facility		£35m	1yr
Local Authorities		£15m	1yr

Note – In addition to the above on a temporary basis and subject to approval by the Treasurer or the Director of Finance an additional £2m (increases amount to £12m) can be invested with Barclays Bank for a maximum of 5 days

40. The proposed criteria for Specified and Non-Specified investments are shown in Appendix B1 for approval.

41. The use of longer term instruments (greater than one year from inception to repayment) will fall in the Non-specified investment category. These instruments will only be used where the PCC's liquidity requirements are safeguarded. This will also be limited by the longer term investment limits.

42. The list of counterparties (who currently meet these criteria) for approval is attached at Appendix B2 along with their current ratings and limits. Definitions of credit ratings are shown in Appendix B3.

Investment Strategy

43. **In house funds** - Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

44. **Investment returns expectations.** Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 2 of 2016. Bank Rate forecasts for financial year ends (March) are:

- 2013/14 0.50%
- 2014/15 0.50%
- 2015/16 0.50%
- 2016/17 1.25%

There are upside risks to these forecasts (i.e. start of increases in Bank Rate occurs sooner) if economic growth remains strong and unemployment falls faster than expected. However, should the pace of growth fall back up, there could be downside risk, particularly if Bank of England inflation forecasts or the rate of fall of unemployment were to prove to be too optimistic.

45. There is an operational difficulty arising from the banking crisis. There is currently little value investing longer term unless credit quality is reduced. Whilst some selective options do provide additional yield uncertainty over counterparty creditworthiness suggests shorter dated investments would provide better security.

46. The criteria for choosing counterparties set out above provide a sound approach to investment in “normal” market circumstances. Whilst the PCC is asked to approve this base criteria above, under the exceptional current market conditions the Treasurer may temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out for approval. These restrictions will remain in place until the banking system returns to “normal” conditions. Similarly the time periods for investments will be restricted.

Investment treasury indicator and limit

47. **Total principal funds invested for greater than 364 days**

These limits are set with regard to the PCC's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year end. A limit for lending for more than one year is set out below:

Maximum principal sums invested > 364 days			
£m	**2014/15**	**2015/16**	**2016/17**
Principal sums invested > 364 days	£3m	£3m	£3m

End of year investment report

48. At the end of the financial year, the PCC will report on its investment activity as part of its Annual Treasury Management report.

Policy on the use of external service providers

49. The PCC uses Capita Asset Services as its external Treasury management advisors. The company provides a range of services which include:

- Technical support on treasury matters, capital finance issues and the drafting of reports;
- Economic and interest rate analysis;
- Debt services which includes advice on the timing of borrowing;
- Debt rescheduling advice surrounding the existing portfolio;
- Generic investment advice on interest rates, timing and investment instruments;
- Credit ratings/market information service comprising the three main credit rating agencies.

50. Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice the final decision on treasury matters remains with the organisation. This service is subject to regular review.